

Internal Revenue Service  
**memorandum**

CC:TL-N-3851-88

Br2:JMPanitch

date: MAY 20 1988

to: District Counsel, Chicago  
Attn: Joel K. Arnold

CC:CHI

from: Director, Tax Litigation Division

CC:TL

subject: [REDACTED]

T.C. Dkt. No. [REDACTED]

The following analysis responds to your request for technical advice, dated February 25, 1988.

ISSUE

Whether I.R.C. § 83<sup>1</sup> applies to the receipt of future profits interests in a limited partnership in return for legal and syndication services performed on the limited partnership's behalf, and, thus, whether section 83 maintains the ordinary income character of the proceeds from a later sale of said interests?<sup>2</sup>

CONCLUSION

Pursuant to G.C.M. 36346 and its attached proposed revenue ruling, a partnership future profits interest is analogous to an unfunded and unsecured promise to pay money or property in the future. Thus, pursuant to Treas. Reg. § 1.83-3(e), section 83 does not apply to the receipt of the limited partnership interests.

FACTS

Petitioner [REDACTED] was a partner in the [REDACTED] law firm of [REDACTED] during the years [REDACTED] through [REDACTED]. On [REDACTED], partners of [REDACTED] and trusts for the benefit of family members of [REDACTED] partners formed a general partnership, [REDACTED]. Between [REDACTED] and [REDACTED], [REDACTED] performed legal and syndication services for a

<sup>1</sup> All section references are to the Internal Revenue Code as in effect during the years in issue, unless otherwise stated.

<sup>2</sup> Our conclusion to this issue renders discussion of issues 2.-7. of your request unnecessary.

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start-up cable television business, [REDACTED]  
[REDACTED], a [REDACTED] limited partnership.<sup>3</sup> [REDACTED] was  
formed in November of [REDACTED]. In return for [REDACTED]'s syndication  
and legal services, it was agreed that [REDACTED] would receive limited  
partnership interests in [REDACTED].

[REDACTED]'s general partners were two unrelated third parties and  
[REDACTED]. [REDACTED] owned all the  
stock of [REDACTED]. It appears that [REDACTED] contributed nothing in return  
for its interest as a general partner. [REDACTED]'s partnership  
interest entitled [REDACTED] to share in the profits of [REDACTED] only after  
the Class A (described below) limited partners received a return  
of their cash contributions or [REDACTED], whichever occurred  
later.

Upon formation, [REDACTED] had two classes of limited partnership  
interests, Class A and Class B (comprising division AB). The  
Class A limited partners, all unrelated third parties, con-  
tributed \$[REDACTED] in cash. The Class B limited partners--  
[REDACTED] and an unrelated third party--contributed nothing to [REDACTED] in  
return for the interests which they received. The Class B  
limited partnership interests entitled the Class B limited  
partners to share in the profits of Division AB of [REDACTED] only  
after the Class A limited partners received a return of their  
cash contributions or [REDACTED], whichever occurred  
earlier. Under the partnership agreement, no partner could sell  
his interest without the permission of the other partners.

As time went on, new divisions of [REDACTED] were formed. Each  
new division corresponded to a new [REDACTED] franchise area.  
[REDACTED] syndicated each of these divisions. [REDACTED] performed the  
necessary syndication and legal services. [REDACTED] received limited  
partnership interests in each of these new divisions in return  
for the syndication and legal services performed by [REDACTED]. The  
limited partnership interests which [REDACTED] received in these new  
divisions entitled [REDACTED] to share in the profits of the correspond-  
ing division only after the limited partners who had contributed  
capital received a return of their cash contributions. Under the  
partnership agreements, no partner could sell his interest  
without the permission of the other partners.

In [REDACTED], the third-party general partners of [REDACTED] wanted to  
"cash out" the interests of some of the [REDACTED] partners. [REDACTED]  
liquidated and distributed the [REDACTED] limited partnership interests  
directly to the [REDACTED] partners. A contract was entered into "as  
of" [REDACTED], wherein [REDACTED]

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<sup>3</sup> [REDACTED] was named [REDACTED]  
[REDACTED] upon formation. The name was subsequently  
changed to [REDACTED]. We will refer to [REDACTED].

██████, a newly created partnership, purchased ██████ limited partnership interests from some of the ██████ partners.<sup>4</sup> Under the terms of the agreement, in ██████, ██████ paid these partners \$██████ cash and a non-recourse, interest bearing promissory note, secured by a letter of credit and payable on ██████. The note was, in fact, paid in ██████. In ██████, petitioner ██████ sold the ██████ limited partnership interests which he had received in ██████ upon ██████'s liquidation.

██████ reported no income attributable to the ██████ limited partnership interests in either ██████ (when the interests were received), ██████ (when ██████ was liquidated and some of the ██████ limited partnership interests were sold) or ██████ (when ██████ satisfied its obligation under the secured promissory note with cash). On his ██████ individual income tax return, ██████ treated the proceeds of the ██████ sale of his ██████ limited partnership interests as long-term capital gain.

The Commissioner determined a deficiency in ██████'s income tax for the taxable year ██████.<sup>5</sup> The Service's theory for attributing this income to ██████ in ██████ is that ██████ originally received the ██████ limited partnership interest as compensation for services rendered, and that no income recognition event occurred until ██████ satisfied its obligation under the secured promissory note in ██████. Thus, ██████'s cash payment in ██████ caused ██████ to recognize income in ██████. The Service has allocated to ██████ a distributive share of the ██████ partnership income in ██████ attributable to the ██████ sale of the ██████ limited partnership interests.<sup>6</sup>

██████ petitioned the Tax Court for a redetermination of the deficiency. The case has been set for trial on the ██████ Tax Court calendar.

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<sup>4</sup> ██████ had also dissolved by this time.

<sup>5</sup> The Service is presently preparing to send ██████ a ██████-day letter for ██████, as well. ██████'s ██████ taxable year is in docketed status with the Tax Court but has not yet been set for trial. Your request involves the applicability of section 83 for purposes of attributing ordinary income to ██████ in ██████.

<sup>6</sup> As discussed below, pursuant to G.C.M. 36346, Sol Diamond, I-176-75 (July 23, 1975), the receipt of a partnership future profits interest does not give rise to compensation income. ██████, however, realized gain from the ██████ sale of some ██████ limited partnership interests. We have asked Branch 1 to contact you regarding the issue of whether petitioner is taxable in ██████ or ██████ on a distributive share of ██████'s gain from the sale which occurred in ██████.

## ANALYSIS

Section 61 includes compensation for services in gross income. Treas. Reg. § 1.61-2(d) directs that the fair market value of property received in payment for the performance of services must be included in income as compensation. Where property is transferred in connection with the performance of services, section 83 includes the difference between the fair market value of the property and the amount paid for the property in the service performer's gross income either at the time the rights of the person having the beneficial interest in such property become transferable or at the time such rights are no longer subject to a substantial risk of forfeiture, whichever occurs earlier. Pursuant to Treas. Reg. § 1.83-3(e), "an unfunded or unsecured promise to pay money or property in the future" is not property for purposes of section 83.

In Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974), the Tax Court and the Seventh Circuit agreed that the receipt of a partnership interest in return for services was a taxable event. On its face, the interest which the service partner received in Diamond was an interest in future profits of the partnership. Although it is arguable that Diamond really involved a shift of an interest in partnership capital from the contributing partner to the service partner, the Tax Court impliedly avoided resting its conclusion on such a finding and the Seventh Circuit expressly followed suit. Diamond v. Commissioner, 492 F.2d 286, 287 (7th Cir. 1974). Thus, in the Tax Court and the Seventh Circuit, a service partner's receipt of a future profits interest in return for the performance of services is a taxable event. However, the transaction involved in Diamond occurred prior to the enactment of section 83 in 1969. Thus, neither court discussed the applicability of section 83 to the transaction therein.

In G.C.M. 36346, Sol Diamond, I-176-75 (July 23, 1975) and its accompanying proposed revenue ruling, the Service concluded that it would not follow Diamond insofar as the Tax Court and Seventh Circuit had held that a partner's receipt of an interest in future partnership profits<sup>7</sup> in return for services resulted

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<sup>7</sup> G.C.M. 36346 defines a partnership future profits interest as an interest which, upon receipt, entitles the recipient to share in only future profits of the partnership. If, immediately after receipt, the interest would entitle the partner to a distribution of partnership assets upon either the partner's withdrawal from the partnership or the liquidation of the interest received, then the interest is not a future profits interest. Herein, [REDACTED]'s limited partnership interests in [REDACTED] would not have entitled [REDACTED] to receive any portion of [REDACTED]'s

(continued...)

in taxable income in the year of receipt. The Service recognized that this position would allow taxpayers to receive capital gain treatment upon the later disposition of something they had originally received in return for services. In order to limit this conversion potential, the Service restricted the capital gain holding of G.C.M. 36346 to the receipt of a future profits interest by a taxpayer as a partner. Receipt of a future profits interest by a taxpayer for services rendered acting in his capacity as an employee or an independent contractor would result in ordinary income pursuant to section 61. Under either scenario section 83 would not apply, however, because the transferred interest is analogous to an unfunded and unsecured promise to pay money in the future and, therefore, is not considered to be "property". Treas. Reg. § 1.83-3(e).<sup>8</sup>

█████ unquestionably received interests in █████'s future profits in return for services performed by the █████ partners. It is a factual question, however, whether █████ partners performed the syndicating and legal services as partners of █████ or as independent contractors. See Rev. Rul. 75-43, 1975-1 C.B. 383, for a discussion of some of the relevant factors to consider.

The unpublished proposed revenue ruling accompanying G.C.M. 36346 indicates that an additional factor which distinguishes between the receipt of a future profits interest by a partner and the receipt of same by an employee or an independent contractor is the intent "that the return for the services be contingent upon the future success of the venture." In the present case, the facts would support the conclusion that the interest was received by a partner. The value of the █████ future profits interests appears to have been highly speculative at the time of receipt. There is no evidence that █████ attempted to sell any of the interests at or around the time of receipt. █████ held the █████ future profits interests for several years after receipt and

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<sup>7</sup> (...continued)

assets if █████ had withdrawn from the partnership or if █████'s █████ interests were liquidated immediately after █████ had received them. Thus, █████'s limited partnership interests were future profits interests.


<sup>8</sup> The wisdom of G.C.M. 36346's conclusion can be seen in the futility of litigating the contrary position. See Kenroy v. Commissioner, T.C.M. 1984-232 (Value of a future profits interest at time of receipt was zero where it was uncertain whether payout would ever be achieved.); St. John v. United States, 84-1 U.S.T.C. para. 9158 (C.D. Ill. Nov. 16, 1983) (Value of a future profits interest at time substantial risk of forfeiture lapsed was zero where it was uncertain whether payout would ever be achieved.).

████ continued to perform services for █████ during this period. Thus, it appears that the █████ partners intended any return for their services to be contingent upon █████'s future success as a commercial venture.

In conclusion, pursuant to G.C.M. 36346 and its attached proposed revenue ruling, a partnership future profits interest is analogous to an unfunded and unsecured promise to pay money or property in the future. Thus, section 83 does not apply to the receipt of the limited partnership interests. Treas. Reg. § 1.83-3(e).

MARLENE GROSS

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Attachment:  
G.C.M. 36346